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TAGS: EPET ENRG PGOV EINV PINR IZ
SUBJECT: IRAQ,S FIRST OIL BID ROUND: TOO HARD A BARGAIN?

REF: A. BAGHDAD 1764
¶B. BAGHDAD 1648

Classified By: Classified by Economic Counselor Michael Dodman, reasons 1.4 (b,d)

¶1. (C) Summary: The Iraq Ministry of Oil's June 30 bid round (ref A) resulted in a winner for only one of the eight fields on offer, leading international oil companies (IOC) and foreign observers to claim that the GOI had failed to achieve its goals. For the most part, however, senior GOI officials have publicly and privately defended the results, noting that the promised increase in production from the Rumaila field, Iraq's largest, will by itself meet Iraq's medium-term goals. For its part, BP executives have told us that they consider the terms they accepted at the June 30 event to be only the beginning of negotiations over the final terms of the contract. In a belated acknowledgment that the June 30 results were not a complete victory, GOI leaders have said they will accelerate the second bid round and look at ways to make it "more effective" than the first round. End summary.

IOCs will not work for peanuts

¶2. (C) The June 30 bid round opened with a bang, with the Rumaila field, the third largest in the world, up for bid first. Exxon bid a 3.1 million barrel per day (mbpd) plateau production target (PPT) at only a $4.80 remuneration fee per barrel. Several IOC executives at the bid round expressed amazement at the bids on Rumaila by both Exxon and BP. An executive from StatoilHydro told EconOff that he did not see how Exxon could economically operate the field under the terms of their bid. Based on calculations performed by an academic expert on oil contracting, the Exxon bid amounted to an approximate 9% internal rate of return (IRR) on its investment. Most IOCs aim for an 8.5% IRR in a stable, low risk, environment like the United States; given the risks in Iraq, the academic would have expected an IRR in the range of 10-20%. The winning bid by BP and CNPC, which accepted the MoO's maximum remuneration fee of $2.00 per barrel, had an estimated IRR of 6%, confirming the assessment of many observers that the BP/CNPC decision to accept the MoO's low remuneration fee was a "foot in the door" strategy. Examination of the Zubair field's bids showed similar results with the IOCs' offers generating an estimated IRR of 6% to 9% and the MoO's maximum fee - which no bidder accepted - generating an IRR of 3% to 5%. (Note: These calculations rely on cost figures provided by the MoO to run simulations for MoO contracting specialists in a course created by the Department of Commerce's Commercial Law Development Program; the calculations contain a small degree of error. The IOCs would have performed more advanced economic modeling. End Note)

BP: We have not yet begun to negotiate

¶3. (C) Before the MoO had even completed the bid round,

members of the BP delegation emphasized to EconOff that this was just the beginning of what they see as protracted negotiations. The head of the BP delegation said that they would prefer not to sign a contract with the GOI just before the January 2010 national elections. However, he also noted that the BP bid expires on January 1, 2010. The $500 million signature bonus becomes due only 30 days after execution (signing) of the contract. BP officials said that there still remain many unknowns around the eventual contract. (Comment: The June 30 results put BP in a relatively strong position as it enters contract negotiations. It provided the only shred of credibility to the bid round, and GOI statements have since trumpeted the production gains they now expect to see from Rumaila. End Comment)

The IOCs play Wii, the MoO plays Pong

¶4. (C) Before the bid round, South Oil Company (SOC) Director General Fayadh Nima said that the fields offered in the first bid round should not be given to foreign companies because the SOC had been working the fields through sanctions and war and was capable of further production increases without foreign help. The production levels the IOCs included in their bids were much higher than Iraq officials had expected, which should go some distance towards convincing MoO insiders like Nima that IOC involvement is essential for Iraq to meet its economic goals. The minimum plateau production target that the MoO designated for each field was well below the actual bids placed: the MoO set the minimum for the Rumaila field at 1.75 mbpd, 57% of the 3.1 mbpd bid by Exxon and 61% of the 2.85 mbpd bid by BP; on the West Qurna field the minimum was 600,000 bpd, or 26% of Exxon's bid for the field.

¶5. (C) Comment: This disconnect between the MoO and IOC estimates on production targets is an indication of a flaw in the MoO's methodology that will need to be corrected if the second bid round is to be more successful. The formula to score and determine winners favored a high production target. The very high production targets that the IOCs bid require greater investment from the IOC; this, in turn, means that the IOCs require a higher remuneration in order to keep an acceptable IRR. However, the remuneration fee, which the MoO calculated presumably based on lower production targets than were actually bid, was the only variable that could be altered after the bid was opened. The system penalized an IOC that bid aggressively to win a field through a high production target. End Comment.

GOI Sees the Glass Half Full

¶6. (C) DPM Barham Salih spoke to Ambassador Hill shortly after the bid round and described the event as an important step forward for Iraq. The Da'wa spokesman and Council of Representatives (COR) Chairman of the Economic and Finance Committee, Haidar al-Abadi, told PolOff that the bid round had been a good event because it set a precedent for the Iraqi people to accept additional international contracts. He said Iraq proved it was a tough negotiator. Abadi said the government was cautious to avoid a political backlash against offering contracts to foreign companies. There has been little public criticism of the BP contract, Abadi said, and this suggests the government can pursue additional contracts with greater confidence in the future. On June 2, according to a French Embassy official, Prime Minister Maliki told the French Prime Minister that he was satisfied with the first bid round and Iraq would proceed with the second bid round without any changes. On the other hand, in a July 4 meeting with MNF-I officials, Deputy PM Rafi Issawi termed the first bid round a failure.

¶7. (U) The GOI's message to the press has been similar. MoO spokesman Assim Jihad told the press that the BP/CNPC consortium will not get even net $2 per barrel from the deal because 35% in taxes and other shares would be taken out. (Note: Under the terms of the bid round, winning IOCs will

form a joint venture with the appropriate MoO operating company - which for Rumaila will be South Oil Company. BP/CNPC will have 75% of the future JV, and SOC will own 25%. Under the model contract the IOC will carry all the JV's costs, but the state-owned operating company will still retain 25% of the profits. $2 minus the 25% SOC share and 35% in tax would yield approximately $1 per barrel for the BP/CNPC consortium. End Note)

¶8. (U) The GOI's positive spin on the first bid round stands in contrast to the negative portrayals in the international press. A typical assessment came from Rochdi Younsi, Director of Middle East and Africa for the Eurasia Group, who is quoted as saying "Frankly I did not think it would be such a fiasco and embarrassment for the government. It shows the level of disconnect between the Ministry of Oil and the oil companies." His words were echoed in numerous other sources.

¶9. (U) The GOI's stance appeared to change in recent days. In comments on July 4, GOI Spokesman Ali Al-Dabbagh said that the government realized the first round "did not achieve the full objectives of the Ministry of Oil," and that the GOI and MoO will "make use of the results of the first round so that the second round will be more effective."

Unlike the Air in Baghdad the Bid Round was Transparent
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¶10. (SBU) Several ex-MoO officials told EconOff they considered the bid round a huge success. Even some who admitted the results were a disappointment said that the transparency that marked the bid round - including televising the full proceedings live - has a precedent value that should not be underestimated and will go a long way towards convincing the Iraqi people that their wealth is not being stolen. One ex-MoO official noted the contrast with prevailing MoO business practices where deals are concluded in back rooms between friends and the friends of friends. Transparency played a prominent role in Prime Minister Maliki's speech before the bid round, and Minister Shahristani also declared transparency as a primary goal in the entire process.

Moving Forward

¶11. (C) The day after the first bid round, July 1, the Council of Ministers approved the offer by BP/CNPC. The consortium is now required to submit a development approach and a performance guarantee, both of which are due by July ¶15. BP's comments prior to the bid round and immediately following the bid round do not support this timeline. BP executives told EconOff that they planned their next trip to Baghdad for late-July. As previously noted, BP expects that concluding and signing a formal agreement with the MoO - which includes working out agreeable terms with the very South Oil Company officials who have criticized the process - will take many months. Shell's experience confirms this assessment: nine months after signing a Heads of Agreement with the GOI to form a joint venture on natural gas development in southern Iraq, Shell is still negotiating the terms of its contract (albeit the gas deal Shell is negotiating is more complicated that the service contract BP/CNPC has won rights to).

¶12. (C) Before formally closing the first bid round, Minister Shahristani invited the unsuccessful bidders to submit revised bids for the fields that were not awarded. MoO officials reported that none of these revised bids came close to meeting the maximum fee. It is not clear what will happen with the seven fields that were not awarded on June 30. In his remarks on July 4, GOI Spokesman Dabbagh said no decision had been made. However, a senior official had previously told us that the Council of Ministers had decided that the two natural gas fields from the first round would be developed by MoO operating companies, and that some or all of the remaining oil fields would be offered in the second bid round (accounts differ: one official said all five fields

would be rebid, another told us that only the three southern fields - West Qurna, Zubair and Missan - would go into the second round, with the two northern fields - Kirkuk and Bai Hassan - to be left to the North Oil Company to work). The GOI has also announced that it will move up the second bid round, although no date was announced. The MoO's contracting department told the press the road show for the second bid round will be in Istanbul in August.

Comment

¶13. (C) One can describe the first bid round as a tactical loss but possibly a strategic victory for Iraq and the MoO. On the tactical level the MoO awarded only one of eight fields offered in the bid round, and 4 mbpd of increased oil production was left on the table. The event displayed huge disparities between the MoO and the IOCs on the capacity of Iraq's oil fields and fees to realize the fields' full capacities. To the world and more importantly the IOCs, the MoO did not seem willing to pay the IOCs a good return on their investment. The MoO and BP/CNPC are still a long way away from a signed deal. On the strategic level the MoO pulled off its first bid round since the 1972 nationalization of the oil industry -- and did so with relatively little political outcry. Iraq now has an awarded bid with an IOC on 15% of its known reserves and a pledge by BP, through the bid, to increase Iraq's daily production by 75% in five to six years after the implementation of the contract. The reactions from the petro-nationalists and those that thought Iraq could do it alone may be silenced by these facts. The question now is what stance the GOI will take as it rushes to prepare for the second bid round. The recent comments from the GOI spokesman acknowledging that some adjustments are needed to make the second round more successful are encouraging, and we will urge senior GOI officials to take such an approach. At the same time, we can expect continued rhetoric about the hard bargain that the GOI forced on BP and CNPC. The GOI needs to calibrate its pre-election rhetoric carefully and avoid setting redlines that will prevent it from offering terms the IOCs are willing to accept. As one former MoO official told us, the best hope is that having realized that the IOCs are able to promise higher outputs from Iraqi fields than the MoO ever believed possible, GOI leaders will have added incentive to make sure the next bid round is a complete success.
HILL